NWU Business School

Policy Uncertainty Index (PUI)

1Q2018

IMMEDIATE RELEASE

12 April 2018

EXECUTIVE SUMMARY

* The PUI for 1Q 2018 fell sharply to 49.6 (baseline 50) compared to 55.4 in 4Q 2017, thus moving marginally into positive territory for the first time since 4Q 2016. It creates a platform from which further reductions in levels of policy uncertainty are possible

* The latest decline in the PUI is the outcome of a combination of favourable political and economic factors over the past three months which have helped to ameliorate political and policy uncertainty. The global economic outlook remains broadly supportive of the SA economy

* The tentative economic recovery of last year has now broadened into a more generalized upturn, with higher levels of business and consumer confidence now also reflected in the lower PUI. A growth rate of about 2% is possible for South Africa in the short term

* Despite positive economic developments there are no grounds for complacency, if South Africa wants to see sustained job-rich growth over the longer term. This will require the necessary economic reforms. There are also still long term risks in the fiscal outlook

* Some tough policy decisions may be left until after the 2019 elections

* How the land reform issue is managed will be an important determinant of future levels of policy uncertainty and investor confidence

NWU-SBG POLICY UNCERTAINTY INDEX (PUI) FALLS FROM 55.4 IN 4Q2017 TO 49.6 IN 1Q2018 (BASELINE 50)

NWU-SBG POLICY UNCERTAINTY INDEX (PUI)

1. INTRODUCTION

As outlined when the PUI was launched two years ago, the role of policy uncertainty has loomed large in much of the recent economic debate in SA. It is seen to have important implications for business confidence and the investment climate in the country. Hardly any recent economic assessment or media release from international or local financial institutions, business lobbies, economic analysts, financial journalists or credit rating agencies appears without the inclusion of the words 'policy uncertainty' occurring in them. *The design of a policy uncertainty index for SA has nonetheless been spurred not only by economic circumstances in the country, but also by the increasing academic and policy interest globally around the cause, effect, measurement and definition of policy uncertainty.*

There have been many manifestations of policy uncertainty in SA over the years. The institutional setting and policy making environment clearly influence the extent to which negative shocks and developments lead to bad outcomes and tough policy challenges. It seemed that the time had arrived to craft a more accurate measurement of this recurrent factor in SA's economic outlook. *A deeper understanding of how uncertainty 'shocks' affect the SA economy helps policy makers to assess how future shocks will impact markets and business.* The outcome of this research will now be made regularly available on a quarterly basis to hopefully fill a gap in our monitoring of the economic environment.

Interesting correlations have been found of the policy uncertainty index with economic outcomes. *Empirically it shows that when economic policy uncertainty is strongly present in the environment, it indeed lowers investment, employment and output.* High levels of such policy uncertainty inhibit meaningful investment and consumption. Elevated policy uncertainty in many countries contributes to sluggish growth. Economic policy uncertainty then has actual consequences for the economy.

Research suggests that uncertainty is very different across economies. Developing countries seem to have about one-third more macro-economic uncertainty than developed countries. However, this is now changing with events such as Brexit, the controversial policies of US president Donald Trump as well as other geo-political tensions.

The PUI is published in January, April, July and October of each year. An increase beyond 50 reflects heightened policy uncertainty; a decline in the PUI means reduced uncertainty. *The value of the PUI as a proxy for policy uncertainty will lie in tracking changes in policy uncertainty over time, and as the index settles down in the period ahead and builds a track record.*

2. PUI RESULTS FOR 1Q2018 - WHAT DOES IT SAY?

The aggregate PUI for the quarterly period January to March 2018 is the average of:

- a news-based uncertainty,
- economists' views on uncertainty,
- manufacturers surveyed by the BER survey and their views on political/policy constraints.

July – Sept 2015	**(Base 50) 50.0**
Oct – Dec 2015	**55.4**
Jan – Mar 2016	**53.6**
Apr – June 2016	**52.5**
July – Sept 2016	**46.5**
Oct – Dec 2016	**38.8**
Jan – Mar 2017	**51.0**
Apr – June 2017	**53.1**
July – Sept 2017	**53.6**
Oct – Dec 2017	**55.4**
Jan – Mar 2018	**49.6**

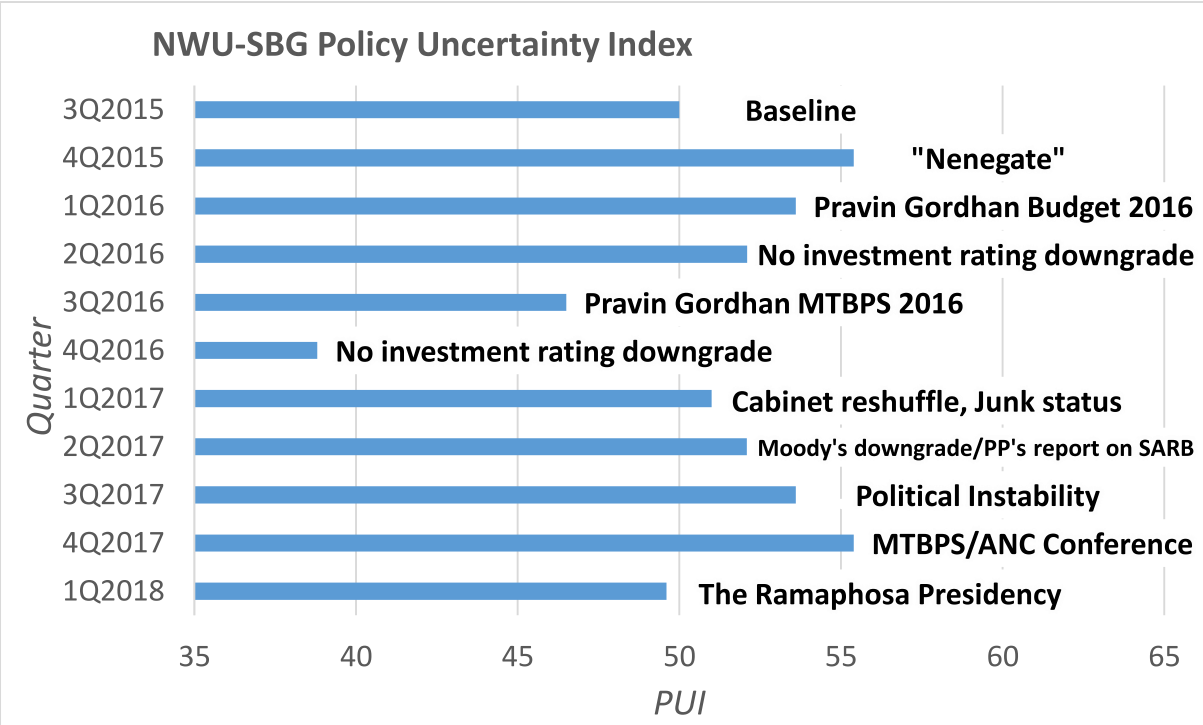
The PUI is the *net* outcome of positive and negative factors influencing the perceptions of policy uncertainty over the relevant period. The outcome for 1Q2018 shows an average score of 49.6, reflecting a decline over the PUI of 55.4 in 4Q2017. *Hence the PUI has fallen sharply and moves back marginally into positive territory for the first time since 4Q2016.*

Unpacking the three elements of the latest index shows the following:

2.1. In the media data there was a decrease in reporting about 'policy uncertainty',

2.2. The survey of the economists shows that their view is that uncertainty was less for consumers and investors (comparing Q1 of 2018 to Q4 of 2017),

2.3. The Bureau of Economic Research at the University of Stellenbosch's latest number on the proportion of manufacturers who indicate that politics is a constraint on doing business in SA fell from 89 to 72.



3. NARRATIVE ON SOME FACTORS INFLUENCING POLICY UNCERTAINTY

3.1 Global Economic Outlook

The global economy has continued to perform well into 2018, with India seen as the fastest growing economy in 2018-19. The major US, EU and China economies are broadly living up to previous growth expectations and world economic growth is still anticipated to be close to 4% this year. International commodity prices have also been steadily recovering since 2016. However, the recent trade policy decisions by the United States could prove damaging to world economic growth if they degenerate into a trade war and promote 'beggar-myneighbour' policies. We must hope that a negotiated outcome to this serious trade conflict is still possible.

At the same time, the counter-cyclical phase of monetary simulation after the Great Recession of 2008, which has partly driven equity markets to a higher level since then, is being gradually being phased out so as to 'normalize' interest rates. After several years of steady recovery in the international business cycle, some upward adjustment to interest rates must be expected, even though global inflation still remains relatively low. These developments will nonetheless have possible implications for global capital flows between developed and developing economies, but which will depend on the pace at which changes in global interest rates occur. Financial markets have shown volatility in the face of some of these recent global developments.

As a whole, however, the current outlook for the world economy is still benign and generally supportive of the SA economy. SA needs to remain globally competitive in order to take full advantage of favourable international economic conditions and as shifts in markets occur. The costs of doing business in SA is a decisive element in SA's ability to capitalize on and exploit positive global market trends as they unfold.

3.2 South African Economic Outlook

The tentative economic recovery of last year has now broadened into a more generalized upturn in the economy, with growth rates of about 1.8% presently expected in 2018, compared with much lower previous forecasts. The economic upturn has become much stronger and will therefore exceed the 1.3% growth rate of last year. The SARB recently forecast a 1.5% rate of growth in 2019 and a 2.0% rate in 2020 respectively. There has been a bounce-back in growth.

The widely expected but critical decision by Moody's in March to retain South Africa's existing investment rating and also to raise the outlook from negative to stable was good news for the economy. By enabling the South African economy to avoid universal junk status the Moody's outcome boosted confidence at several levels, especially business and consumer confidence. This decision by Moody's was made possible by a combination of a recent positive political and economic trends in South Africa which led to an improved assessment of the economic outlook.

Factors such as the election of President Cyril Ramaphosa as President of South Africa, the attack on state capture and other forms of corruption, the reappointment of Minister Nene to the finance portfolio, and difficult decisions in the February Budget all helped to create the scope for Moody's outcome. The Moody's narrative put particular emphasis on how a strengthening in South Africa's institutions, if sustained, will facilitate economic recovery.

The fall in the 1Q2018 PUI and move into positive territory therefore creates a platform for further improvements, if the political and economic environment continues to strengthen.

There are new grounds for cautious optimism about the general outlook, with positive factors pointing towards prescient indicators of change.

Yet there are no grounds for complacency. For one thing, the present strengthened levels of confidence need to be sustained and eventually translated into higher levels of investment to underpin renewed growth and job creation. The challenge to South Africa remains to use the time granted by Moody's reprieve wisely. It must continue to work towards a more transparent and predictable policy framework which would help to further strengthen business and consumer confidence.

Then, although the recent positive developments on several fronts have given South Africa a welcome breathing space, there are still tough decisions (several of which may not in any case be possible before the 2019 elections) needed to implement the structural reforms required to ensure a stronger economic performance over the longer term. The current 'Ramaphoria' economic recovery will not in itself resolve the unemployment challenge, unless other reforms also happen in due course. South Africa has not yet raised its potential growth level. Much higher job-rich growth must remain the goal.

The MPC at its meeting on March 28 rightly decided to cut interest rates by 25 basis points at this stage, albeit on a split 4-3 vote, but cautionary signals were also apparent in the MPC's economic assessment. In an uncertain environment, said the MPC, future policy decisions on rates would remain highly data-dependent and sensitive to the assessment of the balance of risks to the outlook. The scope for future rate reductions would remain subject to the internal and external factors that usually influence monetary policy decisions.

There is, therefore, no guarantee that interest rates will continue to decline in 2018. The outlook will continue to be shaped by factors such as the performance of the rand and trends in the rate of inflation - especially given the expected combined impact on the CPI of the increase in VAT, the higher fuel levy and the sugar tax. A carbon tax is also expected at the beginning of 2019. South Africa must beware of drifting into a negative 'tax-and-spend' cycle which would eventually be damaging to its economy.

Another emerging factor in the economic and business outlook is the uncertainty around the land reform issue. There will be a degree of risk-aversion until the land reform strategy becomes clearer. This is becoming a more important question in the economic scenario as the debate on land restitution unfolds and escalates. It remains essential that the question of landownership be addressed in the interests of social stability and economic justice. But how it is done is vital to market perceptions and investor confidence.

A wrong decision on a matter as fundamental as this carries downside risks for the economy, which is why the government's proposals are appropriately hedged with certain economic conditions, and subject to widespread consultation.

3.3 The 2018/19 National Budget

The 2018/19 Budget expanded on some of the themes in the State-of-the Nation Address and also linked itself to the National Development Plan. It was a considerable improvement on the badly-received MTBPS of October 2017, which was a major factor contributing to the sharp rise in the 4Q 2017 PUI at that stage. At the time of the MTBPS, government debt was shown to be on an unsustainable path which, together with other factors, raised serious concerns and uncertainties. If credibility and predictability in fiscal policy were to be reaffirmed, significant adjustments to the fiscal framework would be needed.

The Budget in February confirmed that, for as long as government spending was not kept under better control, the tax burden would inevitably rise. But given the fiscal constraints, the Budget was nonetheless broadly well-received by the markets and business. The fact that the National Treasury grasped the nettle of raising VAT, thus avoiding having to increase direct taxes, showed a willingness to make difficult decisions in present economic circumstances. South Africa had not adjusted VAT since 1993 and increasing VAT was regrettably unavoidable, if the integrity of South Africa's public finances was to be upheld.

However, although adjustments were made in the Budget to increase social grants to compensate for the rise in indirect taxes and offset their possible regressive impact, Finance Minister Nhlanha Nene has been compelled to asked the Chairman of the Davis Tax Committee (DTC) to have a further investigation into the current list of zero-rated items under VAT. There was a strong negative reaction in some circles to the increase in VAT from 14% to 15% and redress was demanded. The DTC has been asked to report by 30 June 2018 on options available.

The difficulty of juggling the various tax and spending decisions in the Budget was starkly confirmed in the 2018-19 Budget Review:

'Although the outlook has improved, the complexity of the economic and fiscal environment should not be underestimated. Economic growth is tepid, unemployment remains very high, and the finances of major state-owned companies have become more precarious. The extent of corruption and wasteful expenditure in the public sector, together with governance and efficiency challenges in tax administration, have adversely affected tax morality. The medium-term costs of free higher education and training, and public service compensation are uncertain'.

It is clear that, whatever the other immediate improvements in the economic situation, these concerns will continue to shape future fiscal imperatives. There are still long term risks in the fiscal outlook which will need to be successfully managed.

4. CONCLUSION

The decline in the PUI for 1Q 2018 is a positive development, with potential for further improvement. It is additional confirmation that South Africa may have turned a corner in its economic fortunes and that levels of policy and political uncertainty may be moderating. It is still early days, though – and complacency must be avoided. The way the land reform issue is handled in particular will also be critical for future levels of policy uncertainty and investor confidence.

Clearly the pending election in 2019 will inevitably play a key role in deciding the pace at which tough decisions will be taken to implement necessary structural reforms. But there can be no gainsaying the better mood in the economy which has also been captured by the decline in the latest PUI and the message it embodies.

North-West University Business School

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